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## **The Czech Republic: Self-inflicted pain**

***Should the euro area continue to ‘muddle through’ and thus avoid deep recession in 2012, the Czech economy would escape recession as well. But its growth in 2012 will be depressed by the stubborn attempts to meet the fiscal targets, no matter what. A euro area recovery in 2013 and beyond would naturally (by way of stronger demand for imports) help speed up growth in the Czech Republic. In addition, the fiscal consolidation measures will by then become less intense (also because of the next regular parliamentary elections to be held in 2014). Good financial standing of the banking and corporate sectors, relatively low level of household debt, combined with competent policy of the Czech National Bank (determined to keep a very relaxed policy even in face of temporary hikes in inflation) should, by then, help accelerate growth – first of investments and then of private consumption and overall GDP.***

GDP growth has been slowing down throughout 2011, from over 3% in the first quarter of the year to an estimated 0.5% in the last. Consumption, both private and public, has been contracting throughout the year at ever faster speed. In the first quarter private consumption fell 0.1% and public consumption by 0.3%: in the fourth quarter the estimated rates of contraction were already 0.7% and 4.4% respectively. Gross capital formation still increased in the first half of 2011 (chiefly on account of strongly increasing stocks), only to decline precipitously in the second half of the year (this time primarily due to plummeting stocks, with gross fixed capital formation down by about 1%). Foreign trade developments also show clear signs of deterioration. In the first quarter the volumes of exports and imports of goods and services rose by 19.3% and 18.7% respectively: in the fourth quarter the respective growth rates were, according to provisional estimates, 6.2% and 0.8%. Overall, the current estimates suggest that the GDP growth in 2011 was about 1.7-1.8%. The contribution of foreign trade to the overall growth was about 2.8 percentage points (p.p.). The contributions of all other expenditure items were negative (private consumption -0.2 p.p., public consumption -0.5 p.p., gross fixed capital formation -0.1 p.p. and change in stocks -0.2 p.p.).

Even though inflation (driven by hikes in indirect tax rates and in prices of imported energy carriers) surpasses its 2% target, the Czech National Bank keeps the policy rate at 0.75%.

The interest rate on three-month interbank loans has been stable at slightly over 1% which shows that the money market conditions are about normal. Interest rates on loans to non-financial corporations are low and falling (recently at 2.7% on average), interest rates on lending to households are also declining and fairly low especially on mortgage loans (for example, the average interest rate on new mortgage loans extended for 5 to 10 years was 4.1% in November 2011). The financial standing of the banking sector remains very strong, with the most recent Capital Adequacy Ratio of 15.7% (as of end-September 2011). Non-performing loans (currently 5.3% of the stock of loans to households, 8.5% of the stock of loans to corporations) have been creeping upwards. However, even if a 'double dip' scenario materializes, the whole banking sector's stability would not – according to the recent stress tests carried out at the Czech National Bank – be seriously jeopardized. The sector should retain the ability to perform its functions vis-à-vis the real economy, even if its profits get squeezed<sup>1</sup>. (But of course, some of the foreign-owned banks may be ordered to concentrate on helping their 'ailing parents' in the euro area.)

Low nominal interest rates and the strong banking sector did not lead to a monetary expansion. Money supply (M3) stock rose by a mere 3.1% in 2011, with the stock of loans to households rising by 5.3% and to the corporate sector by 5.8%. Neither households nor the corporate sector are in any way over-indebted (the stock of the non-financial private sector's debt falls short of 55% of the GDP). The stagnant demand for loans reflects the negative growth in real incomes of households and in the operating surplus of the corporate sector. These latter developments could only be expected given the orientation of the fiscal policy.

To gain some understanding of the current trends, one has to consider the socio-economic agenda of the current liberal-conservative government (in power since mid-2010). In economic terms that agenda envisages further liberalization of regulations restricting labour market flexibility and entrepreneurship. Operationally, fiscal consolidation has been the highest priority.<sup>2</sup> Active measures carried out to restrict the public sector deficits amounted to about 2.8% of the GDP in 2010. According to the Finance Ministry's *Convergence Programme of the Czech Republic* (April 2011)<sup>3</sup>, further measures to be

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<sup>1</sup> In the first three quarters of 2011 banks' net profit fell nominally by some 3.5% over the same period of 2010. (In current euro terms the net profits remained constant at about EUR 1.7 billion.)

<sup>2</sup> TOP 09, one of the three parties forming the ruling coalition, proudly designates itself as 'fiscally conservative'. The Finance Minister, Miroslav Kalousek, is one of the leaders of the party (which is chaired by Prince Karel Schwarzenberg).

<sup>3</sup> The substance and goals of the Czech government's fiscal consolidation programme were detailed in *wiiw Current Analyses and Forecasts*, Issue 8 (July 2011).

carried out in 2011 were to amount to another 2.1% of the GDP. These measures, including cuts in social benefits, in the public sector wage bill, and other expenditures (as well as further hikes in indirect tax rates) were to push the deficit to 4.2% of the GDP in 2011. In actual fact the deficit in 2011 may have been as low as 3.5%. But that 'success' seems to have come at the expense of the unexpected real growth slowdown and accelerating contraction of consumption and investment. Indeed, the Ministry's July 2011 expectations for 2011 stipulated positive growth in private consumption (+0.5%) and gross fixed capital formation (+1.9%). It foresaw a rise in domestic demand (+0.6%) and a 1.9 p.p. contribution of foreign trade to the overall GDP growth (which was to reach 2.5%). In actual fact domestic demand fell by 1% while the contribution of foreign trade to the eventual 1.7% GDP growth reached 2.8%.

The performance of foreign trade prevented a deep recession in 2011. Some mild nominal (and more pronounced real effective) depreciation of the Czech koruna in the fourth quarter of 2011 may have played a role in supporting growth of exports and – more importantly – in limiting growth of imports. The fact that exports expanded quite strongly even in the fourth quarter of 2011 seems to indicate that the fears about the overall growth slowdown in the euro area (and Germany in particular) may have been exaggerated, so far. Under the assumption of continuing 'muddling through' in the euro area, the Czech economy could avoid recession in 2012. Growth in Czech imports would then be strongly depressed by falling, or stagnant, domestic demand while exports may continue to rise, even though at very moderate rates. Of course, a full-scale recession in the euro area would have devastating effects on Czech exports and overall GDP growth (as in 2009 when exports fell close to 11% in real terms, thereby helping to push the Czech GDP down by over 4%). Worse still, if exports are hit by recession in the euro area, the current government's likely response may be to *tighten* its fiscal stance (for example by raising indirect taxes) so as to offset the shortfall of budgetary revenue.

With the public debt/GDP ratio less than 41%, the Czech Republic would seem to be in no need to enforce radical cuts in current public sector expenditures. The burden of servicing public debt is low and the government does not need to worry about financing its long-term debt (at about 3.4% the yields on this debt are fairly low). The reasons why – given such circumstances – the authorities felt compelled to start a multi-year fiscal consolidation programme go beyond standard macroeconomics. Apparently, the leading politicians believe in some sort of 'supply-side economics'. Right now external conditions diverge from the benign scenario assumed two years ago, at the inception of the programme. Yet this divergence does not result in any visible relaxation of the fiscal policy stance. This inflexibility can have many reasons. One of them is the fact that Czech society at large

seems to be able to tolerate bad policy longer than elsewhere.<sup>4</sup> In May 2011 the Czech Trade Unions did try to organize a general strike to protest the course of economic policy: the attempt failed rather miserably. The fact that so far unemployment statistics do not show much deterioration on the labour market also blunts the public propensity to voice discontent.<sup>5</sup>

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<sup>4</sup> On the same principle the public seems to have become used to endemic corruption in high places.

<sup>5</sup> The Czech economy still disposes of a labour market ‘safety valve’ in the form of a pool of foreign workers (at least 6% of total employment). In 2011 total employment rose (marginally), but the estimated number of foreign workers employed fell by about 2%. Another development bearing on unemployment figures is the tendency for an increase in the number of ‘entrepreneurs and self-employed’.

Table CZ

## Czech Republic: Selected Economic Indicators

	2006	2007	2008	2009	2010	2011 <sup>1)</sup>	2012	2013	2014
	Forecast								
Population, th pers., average	10269	10334	10424	10487	10520	10540	10580	10610	10640
Gross domestic product, CZK bn, nom.	3352.6	3662.6	3848.4	3739.2	3775.2	3835	3930	4060	4260
annual change in % (real)	7.0	5.7	3.1	-4.7	2.7	1.8	0.5	2.5	3.5
GDP/capita (EUR at exchange rate)	11500	12800	14800	13500	14200	14800	.	.	.
GDP/capita (EUR at PPP)	18900	20700	20200	19300	19400	20100	.	.	.
Consumption of households, CZK bn, nom.	1604.5	1719.7	1856.7	1852.5	1871.8	1860	.	.	.
annual change in % (real)	4.3	4.1	3.0	-0.5	0.6	-0.4	-0.5	1.5	2.5
Gross fixed capital form., CZK bn, nom.	860.2	989.6	1031.2	927.5	923.0	920	.	.	.
annual change in % (real)	5.8	13.3	4.1	-11.5	0.2	-0.3	0.5	4	6
Gross industrial production									
annual change in % (real)	8.3	10.6	-1.9	-13.6	10.3	6.9	4	8	8
Gross agricultural production (EAA)									
annual change in % (real)	-4.2	3.1	6.8	-3.6	-7.0	7.1	.	.	.
Construction industry									
annual change in % (real)	6.1	7.0	-0.2	-0.8	-7.1	-3.1	-3	2	3
Employed persons - LFS, th, average	4828.1	4922.0	5002.5	4934.3	4885.2	4904.9	4910	4930	4950
annual change in %	1.3	1.9	1.6	-1.4	-1.0	0.4	0.2	0.5	0.5
Unemployed persons - LFS, th, average	371.7	276.6	229.8	352.2	383.5	353.6	.	.	.
Unemployment rate - LFS, in %, average	7.2	5.3	4.4	6.7	7.3	6.8	7.0	7	6.5
Reg. unemployment rate, in %, end of period	7.7	6.0	6.0	9.2	9.6	8.6	.	.	.
Average gross monthly wages, CZK <sup>2)</sup>	19546	20957	22592	23344	23797	24420	.	.	.
annual change in % (real, gross)	4.0	4.3	1.4	2.3	0.4	0.4	0.5	1	2
Consumer prices (HICP), % p.a.	2.1	2.9	6.3	0.6	1.2	2.2	3.2	2	2
Producer prices in industry, % p.a.	0.1	2.6	0.4	-1.5	0.1	3.7	.	.	.
General governm. budget, EU-def., % GDP									
Revenues	39.6	40.3	38.9	39.1	39.3	39.8	.	.	.
Expenditures	42.0	41.0	41.1	44.9	44.1	43.5	.	.	.
Net lending (+) / net borrowing (-)	-2.4	-0.7	-2.2	-5.8	-4.8	-3.7	-4.0	-3.5	-3.0
Public debt, EU-def., in % of GDP	28.3	27.9	28.7	34.4	37.6	40.5	44	46	46
Central bank policy rate, % p.a., end of period <sup>3)</sup>	2.50	3.50	2.25	1.00	0.75	0.75	0.75	1.0	1.5
Current account, EUR mn	-2391	-5671	-3297	-3428	-4664	-3269	-3200	-3300	-3500
Current account in % of GDP	-2.0	-4.3	-2.1	-2.4	-3.1	-2.1	-2.0	-2.0	-2.0
Exports of goods, BOP, EUR mn	68107	77595	84845	70983	88076	100371	110000	123000	139000
annual growth rate in %	17.9	13.9	9.3	-16.3	24.1	14.0	10	12	13
Imports of goods, BOP, EUR mn	66021	75922	83811	67684	85985	95845	104000	115000	130000
annual growth rate in %	17.5	15.0	10.4	-19.2	27.0	11.5	9	11	13
Exports of services, BOP, EUR mn	11282	12643	14910	13924	15812	15898	16000	18000	20000
annual growth rate in %	18.2	12.1	17.9	-6.6	13.6	0.5	3	10	10
Imports of services, BOP, EUR mn	9556	10512	11949	11126	12839	13200	14000	15000	17000
annual growth rate in %	15.4	10.0	13.7	-6.9	15.4	2.8	3	10	10
FDI inflow, EUR mn	4363	7667	4467	2082	5104	3687	3000	4000	4000
FDI outflow, EUR mn	1172	1187	2964	685	1283	570	1300	1300	1300
Gross reserves of NB excl. gold, EUR mn	23684	23456	26386	28556	31357	31000	.	.	.
Gross external debt, EUR mn	43513	51744	60511	61940	71379	78000	.	.	.
Gross external debt in % of GDP	36.8	39.2	39.2	43.8	47.8	50.0	.	.	.
Average exchange rate CZK/EUR	28.34	27.77	24.95	26.44	25.28	24.59	25.00	24.75	24.50
Purchasing power parity CZK/EUR	17.24	17.17	18.24	18.46	18.47	18.13	.	.	.

Note: Gross industrial production, construction output and producer prices refer to NACE Rev. 2. Gross agricultural production refers to Economic Accounts for Agriculture (EAA).

1) Preliminary and wiiw estimates. - 2) Enterprises with 20 and more employees, including part of the Ministry of Defence and the Ministry of the Interior. From 2009 all enterprises covered. - 3) Two-week repo rate.

Source: wiiw Database incorporating Eurostat and national statistics. Forecasts by wiiw.